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# Future Trends of Latvian Financial Market Development

## 1. Introduction

Baltic region financial markets are comparatively young – the visible development started in the beginning of this century and reached its peak in 2007. The main changes were initiated by the foreign banks acquiring local players and injecting considerable financial base in the form of massive lending. Banking sector assets grew from 5.7 billion LVL in 2003 to 21.3 billion LVL in the first quarter of 2008.[1] The latter resulted in pushing upwards product development and technology as well as employee expertise, parallel to significantly decreasing risk exposure and costs for the local banks. As the result Latvian economy overwhelmed with the GDP growth exceeding 9.4% in the period 2003- 2007. [2]

Infusion of foreign money in the form of loans acted as the accelerator of this fast and obvious advancement. In 2000 number of local banks sold their majority stakes to foreign banks (mostly of Scandinavian origin). The next actions: full acquisition of the banks and retail crediting was rather obvious step. To finish this process and to get fully integrated into the mother company structure the last stage - final rebranding and harmonization of systems is taking place in 2008- 2009. From March 7, 2008 A/S Latvijas Unibanka has become A/S SEB banka, A/S Hansabanka announced to become A/S Swedbank by the autumn 2009.

The upside movement of the economic indicators stopped with the local government applying fiscal and monetary policy instruments besides to implementation of the anti-inflation plan. The external factors lowering the bank lending came in the form of global credit crisis. As global market economy changed the developing phase of the circle to the slowdown and every bank in US and Europe zone almost defaulted, the cost of funds in the financial market rose thus increasing the cost of every borrowed resources.

Besides to the present global credit tumble, financial market in Latvia is facing the shift of economy cycle stage and globalization process challenges. Identification of the future trends of the Latvian financial market development is the main challenge of this article.

## 2. Globalization Processes

Globalization processes spur financial development. "For the European Union, financial integration implies that less financially developed countries will catch up with the more developed ones. Beyond catching up, financial integration also has the potential to produce further market development, including for the European Union's most advanced markets...This forces financial sector players to become more efficient and provides them with various means to do so. It also provides scope for innovation and better rewards innovators. These incentives and opportunities in turn enhance financial markets further, producing a virtuous circle. The result is better and more complete financial intermediation at a lower cost". [3]

As a country with relatively small number of inhabitants Latvia is influenced by globalization processes to the large extent. Local financial markets experienced globalization when in the result of merger and acquisition gained foreign mother companies (most often Scandinavian). For Latvia this process included: rebranding, unifying systems and services offered, personnel training and later becoming the branch of the foreign bank not a separate financial institution. Standardization of marketing policies, financial market products, lending process, human resource selection process etc. shifts the whole level of banking upwards. Still the latter is delivering considerable cost items into mother company Profit and Loss report. The companies are spending and will devote many financial resources for adjusting their products to local law and taxation regulations. The adaptation of banking retail products to the specificity of local marketing and language can bring additional expenses.

Europe has made considerable progress in integrating its financial markets. "In the 1957 Treaty of Rome, the founding fathers of the European Union (EU) set out to create a common market where goods, services, people, and capital could move freely. They thus put Europe on a course toward a single financial market, one characterized by a free flow of capital and the free provision of financial services across borders. Fifty years later, European financial integration has made significant headway, with monetary union perhaps the most visible marker”. [4]

Latvia is just in its way to join European Monetary Union, which will happen not earlier than 2013, where the financial markets will be among the first ones to reflect this change. The important step for Latvian financial market will be shifting to EUR as the currency of investment- LVL devaluation risk and inflation fast growth accelerate this process. All three Baltic stock exchanges operating with one currency will make investors more “mobile” between the three markets and should positively influence their liquidity as the local investors who do not want to exchange the currency or have other currency exposure now will operate in EUR. EUR trading project is being lobbied by NASDAQ-OMX group.

“It is tempting to conclude that global capital markets have reached the point of no return. Capital flows across borders have risen to new heights. This is true first and foremost of foreign direct investment, which has been stimulated by enterprise privatization, the development of global production networks, and the ready availability of finance for mergers and acquisitions”. [5] The previous financial services retailers in the result of mergers and acquisitions became the wholesalers where the relative weight of the leading banks is increasing. If observed the share of Top 5 Latvian banks as the percentage of the total assets of region banks, then the global trend, where the weight of the major players is increasing, is present. Out of 24 banks registered in Latvia, the asset weight of Top 5 is stable within 65-70% with the tendency to reach 70%. [6] The increasing role of the global players is delivering also the considerable risks of the whole economy dependency on the performance of several financial institutions thus delivering the positive correlation between the performance of the institution and the economy growth.

## 3. Competition Squeeze

"At a sub-level, we can think of the economy ultimately as a vast collection of beliefs or hypotheses, constantly being formulated, acted upon, changed and discarded; all interacting and competing and evolving and coevolving; forming an ocean of ever-changing, predictive models-of-the-world ." [7]

Growing competition of the global players in the local market will result in margin squeeze. Struggling for market share or targeting to sell their products, global players can afford zero-margin short to medium term operation as having the direct access to the stock exchanges, resources and research. In the result of joint venture formed in January 2006 between Norwegian DnB NOR and German NORD/LB Norddeutsche Landesbank, in Latvia started to operate DnB NORD bank putting the stress on lending as well as attracting money by deposits. [8]The average lending rates were Interbank rate + 0.5% (for example 6 months Euribor + 0.5%) or about 30 bps less than the lowest provided by the other banks, the deposit rates were 10% for LVL 1 year deposit or on average 2% more than the other banks. “Corporations that were mainly focused on local markets have extended their range in terms of markets and production facilities to a national, multinational, international or even global reach. These changes in industrial structure have led to increases in the power, profits and productivity of those firms that can choose among many nations for their sources of materials, production facilities and markets, quickly adjusting to changing market conditions”.[9]

The banks will focus on the areas where they have competitive advantage. Existing and new players will continuously search the areas of banking for new opportunities to capture business, by offering more competitive terms. The absolute winner of the competition squeeze is the final consumer of the financial services.

Global players’ efficiency and cheap resources will eliminate the big number of local banks: liquidity problems have brought the significant raise to the cost of money, thus pushing up for the banks the cost of lending. In this situation the global players will survive because of accessing the cheap financial resources whereas the smaller institutions will have to raise the cost of lending thus accessing just the less qualitative loans. The latter will deliver significant pressure for the rise in the bad loans and thus potential writedowns in the case of the distress of the local economy.

In the future there will be small operation segments left for the small local players (mostly supported by the Eastern European capital like PrivatBank, Trastakomercbanka, Latvian Business Bank, etc). Those banks will survive because of the more generous payments for deposits (deposit rate difference for 1 year EUR deposit between Scandinavian SEB banka and Privatbanka reached 2.75%) besides to the lower risk control than the global players meaning more flexibility and big client need satisfaction.[10]

## 4. Technological Development

Technological improvement is one of the key aspects of the future development of global capital market. The improving and new technological solutions are used to develop new products, increase operational efficiency and by raising the competitiveness to increase the customer satisfaction. In Latvian financial market Internet banking and online payment/ investment solutions are squeezing the traditional personal service. The process is accelerated by banking sector services standardization and becoming a one-stop shop of financial products as well as high Internet user ratio in the region. Conservative lending policy of the banks (applied as the consequence of economy overheating with inflation and interest rates raise) is currently speeding the shift from credit providing operations, which involves much direct contact with the client (submission of documents, various signatures), to the more balanced one between crediting and investment operations. The qualitative change of investor base is supporting this process- private banking is being substituted by retail banking.

Traditionally Eastern European money was the main source of investment, where the local resources were comparatively low. With the emerging of the middle class and 2nd pension pillar introduction Latvia gained the solid base of the local money thus forming the investment resources. The severe international regulations like Anti Money Laundry Policy and Markets in Financial Instruments Directive (MiFID) increased customer and money origin transparency thus squeezing many Eastern European clients from Latvian investment banking. In the result there are two investor groups present: retail investors represented by middle class workers- intensive Internet users with stable income and high requirements for the partner they are working with (bank), and institutional investors- mostly asset management companies aiming for high volume investment, which requires reasonable technological solution in place. Besides to the international players are eager to overtake the business in case the local banks cannot manage it.

Going more retail undermines the higher demand for Internet banking. At the moment only 2 local banks: A/S Hansabanka and A/S Parex banka are providing Internet solution as the means of accessing investment opportunities. In the coming years more banks will join this sample- client relationships are becoming more impersonal.

Product standardization and retail customer product targeting will make them available in the Internet. In the absence of money transaction costs (like European transactions); account opening and maintenance costs will make it easy to compare and select the best product and immediately buy it in the Internet bank. Current account will be just the means of getting new customer to the bank- not profit bringing instrument. The profit stress will be more shifted to investment services.

Technological development will increase competition in the financial sector by lowering the transaction costs. "Technological advances that have significantly lowered the costs of transportation and communication and dramatically lowered the costs of data processing and information storage and retrieval comprise one such source".[11] Still the shift to Internet based banking can attract more foreign not locally based financial market players as the physical movement to Latvia will not be necessary and the market access will require less entry barriers.

## 5. Market Complexity

Global market development is increasing the complexity of financial instruments where the traditional ones like deposits, stocks and bonds are getting replaced by capital guaranteed products, options and credit default swaps. The globalization factor is spreading the positive market experience through the boarders fast. As the result new instruments are appearing: structured finance (in-house derivatives), capital- guaranteed products. Driven by the demand of margin reduction for borrowers and higher return for investors, the financial instruments are becoming more complex and thus less transparent for the customer. With global financial institutions bringing the global products to the markets, the number of customers possessing the global risk exposure is increasing. "Falling transactions and information costs have led to a reduction in home bias and to an increasing volume of two-way capital flows. The results are evident in a rise since 1990 in the share of residents holdings of foreign bonds and equity relative to domestic bonds and equity in countries like Canada, Germany, Japan and the United Kingdom." [12]

The geography of the investment will also be challenged as less developed and thus potential riskier and higher interest earning markets are present. Raising Baltic economical risks current investments can be reallocated to other emerging markets. Once Latvian financial instrument market provided attractive risk/return relation for the investors- the returns were high where the risk factor was fully understood and to the very high extent "possible to be influenced" because of the relative lack of market development and low liquidity and trading volumes. Thus absolute extra return was driving financial market development. As the risks are growing fast (economy slowdown, unattractive macroeconomic indicators), the local bonds are losing their attractiveness giving the way to more appealing risk/ return areas.  The second zone of local investors' concern is the significant liquidity and volatility risk of the investment positions. The latter makes it difficult to buy the reasonable amount of securities in Latvian market and then to sell it without the significant change of the price. Moreover every big position opening/ closing cannot be done without the notice of the whole market. Market globalization and technological development processes will result in more open position hedging need as the investor once they are exposed to the market will want to have hedging instruments or channels through which they can exercise opposing views to the trend of the market.

## 6. Conclusion

Latvian financial market is lacking long-time development traditions and experience- the strong growth took place during the last 5 years. Latter was accelerated by the invasion of global financial institutions acquiring local banks. Strong GDP growth and retail consumption were stimulated by the credit availability still resulted in the overheating of the economy. Currently the future trends of the Latvian financial market are not sound- traditional global absorption of one region troubles is not in place due to the global market distress.

Globalization influence unifies the products offered, IT systems, accounting practices while spreading the accumulated experience and best market practices. Global market development is increasing the complexity of financial instruments. Still with global financial institutions bringing the global products to the markets, the number of customers possessing the global risk exposure is increasing. The increasing number of financial instruments will drive the development of local market thus increasing the number of its participants.

Zero-margin operation is the feasible short- middle term competition squeeze policy for the international players while acquiring the local market share. In these conditions the banks will focus on the areas where they have competitive advantage where the global players' efficiency and cheap resources will eliminate the big number of local banks. The banking sector will be divided into international bank branches (mostly Scandinavian) as retail service providers and Eastern European banks as the private banking service providers.

Credit market crunch and conservative lending policy of the banks is shifting Latvian banking sector to the more balanced lending/ investment direction thus increasing the role of technological solution. Raising Internet usage and the availability of global players' solutions via Internet is bringing the resource concentration to the technology development. The latter is accelerated by the change of the current account role, decrease of transaction costs and product standardization. Still the shift to Internet based banking can attract more foreign not locally based financial market players as the physical movement to Latvia will not be necessary and the market access will require less entry barriers.

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